

# INTERNAL AUDIT REPORT

RALEIGH BUSINESS & TECHNOLOGY CENTER INC.

**CONTRACT AUDIT** 

June 2013



Date: July 3, 2013

To: Perry James, Interim City Manager

From: Martin Petherbridge, Internal Audit Manager

Re: Raleigh Business Technology Center Inc. Contract Audit, June 2013

The attached report contains the results of our audit of contract compliance by the Raleigh Business Technology Center Inc. (RBTC) and the City of Raleigh's (City) management of their contract. This review was conducted at the request of the City Manager's Office.

Our audit found evidence of contract non-compliance, program management issues and inadequate administration of the RBTC relationship and contract. Our recommendations are addressed to the City Manager. The City Manager's formal response is included in the report.

# **Table of Contents**

	Page
Introduction and Overview	1
Audit Objectives, Scope and Methodology	2
Limitations to the Audit	3
Findings, Recommendations and Responses:	
1. Contract Non-Compliance and Financial Management Weaknesses	3
2. Program Management Issues	7
3. City Administration of the RBTC Contract and the Facility	9

#### Introduction

The Internal Audit Office has completed a review of contract compliance by the Raleigh Business Technology Center Inc. and the City's management of their contract. This review was requested by the City Manager's Office and made part of the 2013 Annual Audit Plan.

#### Overview

Discussions about a City of Raleigh sponsored incubator can be traced back to the 1980s. In 1998 the City and other community organizations committed to the idea of a facility dedicated to small business incubation. Land and funds totaling \$ 907,000 were provided by the City, and a grant for \$500,000 was secured from the US Economic Development Administration (EDA). In 2000, the City opened the business incubator, a 16,838 square foot facility located on the corner of Wilmington Street and Martin Luther King Boulevard, called the Raleigh Business and Technology Center.

From 2000, the City arranged for Raleigh Business and Technology Center Inc. (RBTC) to provide a business incubator program for its tenants. RBTC maintains its offices in the facility and rents approximately 30 units to business start-ups at below market rates. Tenants benefit from several shared services, including access to the internet, conference rooms, and a copy machine.

In December 2002 the City contracted with RBTC to provide a similar service to non-tenants. The Pacesetter program is intended to provide the education, support, networking opportunities, and strategies needed for small businesses to survive and grow.

A world-wide recognized organization for the advancement of business incubation and entrepreneurship, the National Business Incubator Association, describes business incubation as:

"A business support process that accelerates the successful development of start-up and fledgling companies by providing entrepreneurs with an array of targeted resources and services. These services are usually developed or orchestrated by incubator management and offered both in the business incubator and through its network of contacts. A business incubator's main goal is to produce successful firms that will leave the program financially viable and freestanding. These incubator graduates have the potential to create jobs, revitalize neighborhoods, commercialize new technologies, and strengthen local and national economies. Critical to the definition of an incubator is the provision of management guidance, technical assistance and consulting tailored to young growing companies."

RBTC is a non-profit organization with a board comprised of representatives from local community and educational organizations. Their mission is "To provide entrepreneurs,

start-ups, and small business owners with the tools for commercial and financial success through sustainable economic and community development programming."

RBTC offers several economic and community development services outside of the Tenant and Pacesetter incubator programs. The City, other governments and non-profit organizations utilize these services to help meet their own objectives.

RBTC revenues were approximately \$800,000 in 2011 and \$450,000 in 2012. The City paid RBTC \$162,000 for the Pacesetter program and small business services in both years. Rent income from the facility's tenants is also a significant source of revenue.

City oversight of the RBTC relationship has recently transitioned to another executive manager in the City Manager's Office.

# **Audit Objectives**

Our objectives are developed during our planning process and reflect our assessment of risk associated with the City contract and RBTC's operations.

The objectives of our review were to:

- 1. Evaluate RBTC compliance with the financial management aspects of the City contract:
- 2. Evaluate RBTC business incubator services in comparison to industry recognized best practices;
- 3. Assess the adequacy of the City's administration of the RBTC relationship and contract.

# **Scope and Methodology**

We conducted this audit in accordance with generally accepted government auditing standards issued by the United States Government Accountability Office.

This audit covered RBTC financial management and two incubator programs for the period July 1, 2010 through December 31, 2012. Our audit did not review the other programs provided to the City, other governments and non-profit organizations.

To achieve our objectives, our work included the following procedures:

- 1. Examining the RBTC contract and other supporting documentation.
- 2. Examining supporting documentation for program expenses and monetary exchanges.
- 3. Interviewing RBTC management and service providers;
- 4. Analyzing financial data and documents including audited financial statements;
- 5. Reviewed research conducted by the University of Michigan's Institute for Research on Labor, Employment and the Economy, the State University of New

York at Albany, the National Business Incubator Association (NBIA) and Cybergroup Inc. and funded by the U.S. Department of Commerce Economic Development Administration. This research identified business incubator best practices that have the most positive impact on client outcomes.

#### **Limitations to the Audit**

- 1. RBTC financial statements were audited by accountants not licensed in North Carolina, and they cannot be relied upon.
- 2. Conclusions concerning some financial transactions were based on limited information provided by RBTC. We did not receive documentation to support many of the transactions identified in the check registers, bank statements and trial balances.

# Findings, Recommendations, and Departmental Responses

# **Contract Non-Compliance and Financial Management Weaknesses**

Our audit procedures identified several instances where RBTC is not in compliance with the City contract. In addition, we found significant weaknesses in their financial management. These are documented below:

# 1. Contract Non-Compliance

#### I. Loss of Tax-Exempt Status

RBTC lost its federally approved tax-exempt organization status on May 15, 2012 because IRS Form 990 had not been filed for three years. The contract between the City and RBTC states:

"In order to qualify for the actual receipt of cash from the CITY of Raleigh, it is necessary that..... B - The agency....be certified by the Federal Government as a tax-exempt organization under 26 United States Code 501(c)(3)."

As a for-profit entity, RBTC may be required to pay taxes and may be subject to back taxes and penalties for not filing.

# II. Insufficient Documentation to Support Disbursements

The contract states "All records supporting the disbursement of funds should be retained for a period of five years." We judgmentally selected 57 disbursements in 2011 through 2013 to test the sufficiency of supporting documentation. Sufficient documentation is necessary to validate the business purpose behind

disbursements. Our testing found some documentation either inadequate or missing for 51 payments totaling \$101,700. Our results included six checks paid to the executive director for a total of \$940 and an \$18,720 check paid to a trust account.

Of the 51 payments, 32 were teller checks totaling \$65,355. Teller checks are used to withdraw currency from an account. At the time of the audit inquiry, RBTC had no documentation to show how the currency was used.

RBTC has since obtained documents from the bank that show that 16 of these teller checks worth \$40,374 were used to purchase cashier checks. Although there are no invoices to support these payments the cashier's checks at least show payments were made to a third party. RBTC cannot account for how the currency was used for the remaining checks.

# III. <u>Insufficient Governance of Related Party Transactions</u>

RBTC trial balances and check registers suggest that several large financial transactions occurred in 2011 and 2012 between RBTC and related parties, board members and management. We could not find evidence in the board minutes provided to us that they were evaluated for possible conflicts of interest. In addition, the transactions were not disclosed in the financial statements. The lack of transparency surrounding the following transactions is of particular concern to the City:

- \$31,000 loan to RBTC by a board member (source: Trial Balance);
- \$3,100 in loan payments to a different RBTC board member (source: Check Register);
- \$3,486 in loan payments made to the RBTC executive director (source: Check Register);
- \$66,000 in "short-term financial support from (an RBTC board member) in the amount of \$66,000 to ensure continued operations." The board member was then a senior City employee. It appears to have been satisfied, as it is not listed in the 2012 trial balance (source: 2008 Board Minutes);
- \$13,000 loan from RBTC to a church for which a board member is the pastor. The loan appears to have been satisfied as there is a zero balance in the 2012 Trial Balance (source: 2012 Trial Balance);
- \$290,000 paid for services to an organization in 2011-12 that was co-founded by the executive director. A current RBTC board member also serves on the board of this other organization (source: Check Register);
- \$500 donated to an organization for which an RBTC board member is the registered agent and director. The RBTC executive director is also listed as a director of that organization (source: Check Register).

The contract states:

- "The board of directors or program administrators will include in the agency's bylaws or adopt by resolution a conflict of interest policy. The policy should state that the board members and employees shall avoid conflicts of interest and any conduct which may suggest the appearance of impropriety when exercising their responsibility to the agency. This statement should preclude board members and employees from benefiting directly or indirectly from the agency's activities except in their role as board member or employees."

Related party transactions can result in favorable terms for the parties involved and transparency is a control to mitigate the risk that this occurs. RBTC has not developed a conflict of interest policy to address these types of related party transactions, or provided a sufficient level of transparency into the stewardship of its funding.

# IV. Audited Financial Statements Submitted Late

The contract states that financial statements audited by a certified public accountant are due to the City within 120 days of the close of the agency's fiscal year. Audited financial statements have not been forwarded to the City in the time period required, see table below:

Financial Year	Due Date	Date Remitted*	Days Delinquent
2009	4/30/2010	9/12/11	500
2010	4/30/2011	9/12/11	135
2011	4/30/2012	2/26/13	303
2012	4/30/2013	Not submitted at the date of this report	

<sup>\*</sup> Date Remitted is from the opinion page of the audit report. Statements would have been delivered to the City after this date.

The City's ability to make informed decisions concerning its relationship with RBTC cannot be made when financial statements are not submitted timely.

#### V. Bank Reconciliations not Performed

The contract requires the bank account be reconciled at least monthly. We found bank statements were not reconciled on a monthly basis, there were inaccuracies in the reconciliations we tested and we could not find evidence that they were reviewed by the board or management. An absence of review will be part of the reason why \$1,190 in bank fees were incurred during 2011-12 for checks returned for insufficient funds.

These five contract compliance findings question RBTC's commitment to honor the terms of the contract. The City may be incurring reputational damage for continuing to do business with an organization that has not complied with the terms of its contract.

#### Recommendation

The City should consider whether it should continue to do business with an organization that does not comply with financial requirements of its contract.

# 2. Financial Management Weaknesses

Beyond the financial requirements of the contract, our audit procedures identified the following instances of financial management weaknesses that are also of concern to the City.

# I. <u>Delinquent Payroll Taxes</u>

RBTC is not in compliance with Federal and State laws requiring the remittance of employee payroll taxes. The trial balance for December 31, 2012 shows payroll taxes totaling \$57,500 are owed to the Internal Revenue Service, North Carolina Department of Revenue and the Employment Security Commission for four employees. These tax liabilities appear to have accumulated at least over the past two years. Tax regulations require prompt remittance of payroll taxes, and failure to do so can result in personal liability for board members and management. The City should consider any possible reputational risk incurred from doing business with an organization that does not comply with payroll tax regulations.

#### II. Excessive Program Expense coded to the Pacesetter Program

Financial records for the 2012 Pacesetter Program included accounting expenses for the program totaling \$23,750. Compared to the \$25,000 costs to deliver Pacesetters training, these expenses are excessive. This accounting for funds suggests the City is not getting the best value from RBTC's Pacesetter program services.

#### III. Financial Viability of RBTC

We found evidence that RBTC is relying on loans from board members, delinquency in paying bills and writing checks that are returned for insufficient funds. Financial statements prepared for years 2007 through 2011 all include 'going concern' footnotes that question the financial viability of RBTC. Though the financial statements cannot be relied on, they show fund balance deficit increased from (\$128,258) to (\$217,070) and together with other evidence, indicate that RBTC is asset insolvent. The City should question whether RBTC's

precarious financial position will impair its ability to continue providing a satisfactory level of service.

**Recommendation** – The City should consider whether it will incur reputational damage by continuing to contract with an organization with such financial management weaknesses.

# **Program Management Issues**

#### 1. Ownership of the Pacesetter Program

The RBTC Pacesetter program is a core deliverable to the City, yet the program intellectual property, curriculum and content is owned by a sub-contractor. By not having ownership of the program, RBTC would be unable to deliver the Pacesetter program if the sub-contractor was unable to continue the program. An incubator should have ownership of its core services.

# 2. Business Incubator Program Practices

Our audit steps compared RBTC operations against NBIA best practices. The original 2003 Pacesetter business plan aligns with NBIA best practices but program operations differ from both the original plan and NBIA best practices. We identified the following findings and opportunities for improvement:

# I. Targeting of Pacesetter Candidates is Different to the Business Plan

The eligibility criteria used to select the most recent Pacesetter candidates are that the business owner should reside, have a business location, or provide services in Wake County. These criteria differ from the Pacesetter business plan, which states that the target candidates should be business owners in the south-east Raleigh area. As a result, the City may be providing services that do not benefit the intended target area. The targeted candidates should be aligned with the intentions of the business plan.

# II. Applicant Selection Criteria are Missing

The interview and selection process used to identify possible Pacesetter and Tenant program participants have eligibility requirements to apply but they do not have formal criteria for selecting the candidates. Selection criteria would help ensure processes are consistent, objective and fair, and add credibility to the program. NBIA best practices recommend that a business incubator develop selection criteria for program applicants.

#### III. Participant Needs Assessment not Performed

A need's assessment for each Pacesetter and Tenant program participant is not performed and individual goals and milestones based on these needs are not defined. A needs assessment would allow mentoring and coaching to be targeted to those where additional services are warranted. NBIA best practices recommend that a business incubator create a needs assessment and a coaching and mentoring plan for each participant.

# IV. Limited Information Collected to Assess Program Effectiveness

RBTC does not collect sufficient information for measuring outcomes to show the effect of their programs. While Pacesetters are asked by the program facilitator to provide their revenue information quarterly and to share successes in the classroom, the information is not formally gathered and submitted to RBTC. In addition, this type of information is not gathered after graduation. NBIA best practices recommend program evaluations be performed. A business incubator should collect sufficient information so that it can periodically perform comprehensive evaluations of the effectiveness of its programs.

# V. Excessive Length of Tenancy

Policies that address tenancy lease renewals were not implemented. Our audit procedures identified two tenants who have occupied leased space in the facility for over nine years. This time period significantly exceeds the RBTC incubation target of 24 months and industry best practices. The NBIA reports that the average length of services offered to incubated clients was 33 months with a range of 1 to 72 months. These two tenants may be occupying space and receiving services that could be directed to more viable business start-ups. NBIA best practices recommend that a business incubator implement criteria to determine when a tenant is ready to graduate and move out of the facility.

# VI. Absence of Tenant Policies – Rental Payments

Policies that address slow or nonpayment of rent by tenants are not documented. NBIA best practices state that the incubator should use mechanisms for addressing slow payment or nonpayment of rent. A formal policy provides assurance that all tenants are treated consistently and serve as a reminder to the organization of the importance of collecting rent to sustain its mission.

# VII. <u>Inconsistent Marketing</u>

Marketing of the Pacesetter program and its participants is inconsistent and marketing the Tenant program is not addressed in the business plan. The marketing plan is part of the Pacesetter 2003 business plan and does not address the Tenant program. Marketing is an important strategy to achieving the missions

of both the incubator and its clients. NBIA best practices suggest that a business incubator develop and implement an effective incubator marketing plan.

# VIII. Absence of Monthly Budgeting

RBTC did not use a monthly budgeting process to manage its revenue and expenses. Further, there is no evidence that quarterly financial statements were prepared. NBIA best practices state that budgets be reviewed each month against actual revenues and expenditures. Some of the issues described earlier in this report may have been mitigated if RBTC performed basic analysis of its financial information.

**Recommendation** – These program findings demonstrate RBTC is not meeting industry best practices that have the most positive impact on client outcomes. In future, the City contract should require that a business incubator follow industry standards. The expected quality of services should be defined, together with measurable outcomes.

# City Administration of the RBTC Contract and the Facility

Our audit procedures identified issues with how the City has managed its relationship with RBTC and the facility that RBTC occupies:

# 1. Insufficient Specificity in Contract Deliverables

The current City contract references the RBTC strategic plan as the statement of work. The plan is broadly written and can be interpreted to include all of the services provided by RBTC. Quality of service is not defined. Without clearly defined deliverables, the City may be paying for services it does not require, and cannot determine if services are of acceptable quality.

**Recommendation** – Future contracts should include a detailed scope of work that defines the nature and quality of services that the contractor will deliver and measurable outcomes that can be used to evaluate contractor performance.

#### 2. Compliance with Federal Grant

The City should ensure that it continues to be compliant with the covenants of the federal grant, from the US Economic Development Association (EDA), that funded construction of the facility. The City is the owner and mortgagor of the facility in which RBTC operates and is responsible for ensuring compliance with the federal covenants through the year 2020. The covenants are documented in a lien attached to the property deed and also documented in 13 Code of Federal Regulations Part 314. Consequences for non-compliance with the covenants include repayment of a percentage of the \$500,000 grant.

The following risks to compliance are identified:

- The Economic Development Administration (EDA) requires that a lessee provide adequate compensation to the property owner. There is no valid lease, and there are no reliable records that indicate RBTC has ever paid rent or that the City has ever received rent. The lease arrangement for the facility should be clarified.
- The EDA requires the owner to keep the property in good condition. City Facilities Management division is not tasked with maintaining the facility and is unaware of its condition. We do not know if RBTC has performed all necessary maintenance to the facility. In addition, at the start of this audit, the facility was not insured by the City. Insurance coverage has since been arranged.
- Incidental and other uses of the facility not specified in the covenants must be approved by the EDA. RBTC provides other non-business incubator services from this facility. Four tenants, current and prior, are service providers to RBTC. Further, there is a non-profit organization registered in another state that leases rooms in the facility. We do not know if EDA has approved these additional uses.

**Recommendation:** - The City should create a lease that includes payment terms and uses of the facility that are acceptable to the EDA. Responsibility for maintenance should be formally assigned.

# 3. Program Placement in the City of Raleigh Structure

Economic development services are managed by the Department of City Planning. An incubator program is an economic development strategy yet the current contract is managed by the Chief Information and Community Relations Officer. Assigning these contracted services to the department of City Planning would offer an opportunity to align them with other City economic development services.

**Recommendation** – Regardless of the direction the City takes with RBTC, consideration should be given to moving management of the small business incubator service contract to the Department of City Planning. Whoever is ultimately responsible should develop a comprehensive plan for managing the business incubator service contract that will ensure that these City management issues are addressed.

#### City Manager's Response:

As noted in the overview to this internal audit, the City originally arranged in 2000 for the Raleigh Business and Technology Center Inc. (RBTC) to provide a business incubator program within a City-owned facility to assist business start-ups which would occupy and pay rent on units within the center. This purpose was later expanded to allow RBTC to provide similar support to non-tenants of the center. Throughout the past 13 years, the City has continued its financial support for this enterprise.

The internal audit noted significant issues where RBTC is not in compliance with the City contract and is also not following appropriate financial management practices. These have led to the current loss of the IRS tax-exempt status for the organization and incurrence of delinquent payroll taxes. It is also of major concern that there are a number of related party transactions noted in the audit that could represent conflicts of interest. Wide-spread lack of documentation and absence of monthly budgeting practices further leave many financial and programmatic issues unresolved as well.

City Administration has reviewed these issues and, as a result of the serious audit findings, will be taking the following steps:

- City Administration will notify the RBTC Board of Directors in writing that a contract will not be approved for Fiscal Year 2013-14 and that RBTC should vacate the City-owned property by July 31, 2013.
- Current tenants of the center will receive notification that they may negotiate short-term lease agreements with the City for continuation of their current space until longer-term plans of the City are developed.
- The City's Building Maintenance Office will perform a physical review of the facility and will advise management of a recommended property management service to maintain the facility until the City's plans are developed for future use of the property.
- The City will begin a review of such future uses of the facility that are consistent with the original City objective for a business incubator that is of value to the overall economic development of the City as well as the stakeholder community interests. This review will be managed through a collaborative effort of the City Manager's Office, the City of Raleigh Planning and Development Department and other appropriate areas. Such plans will need to be in compliance with the covenants of a federal grant from the Economic Development Administration that funded construction of the facility. We anticipate that the review will occur within six months and that, based on this review, the City will make decisions on how then to move forward.
- Programmatic and financial oversight will be incorporated into future City practices and contractual agreements.
- Further review will also be made of issues identified in this report to determine if there are other disclosures and notifications that the City should make to outside entities.

Martin Petherbridge CPA, CIA Internal Audit Manager

June 30, 2013

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